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Fitch Meeting Addresses Early Efforts at Modifying Scales

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By Dakin Campbell

Fitch Ratings yesterday issued a summary of a recent meeting to discuss a change to the municipal rating scale that would put it more in line with corporate debt.

One week ago today, Fitch hosted a group of issuers and investors at its New York City office to discuss the relative merits and drawbacks to changing the municipal scale. Attendees were large governmental issuers and some of the market's most active investors, including representatives of several mutual funds and one hedge fund.

"This is a very big issue here at Fitch and we are trying to work as efficiently as possible, and this was a very helpful format," said Robert Grossman, Fitch's chief risk officer and the man in charge of the rating review. "I think we got a tremendous amount of information that wasn't available at an individual meeting."

Grossman said Fitch will continue to meet with individuals, while also hosting several more group discussions.

In the most recent meeting, the idea of mapping munis to corporates centered on the potential to bring a larger group of investors to municipal credits, Fitch said, potentially bringing down the cost of borrowing for issuers. Attendees agreed that in recent years, as the market has become more globalized and exposed to a wide array of economic factors, the need for revisiting the municipal scale has taken on greater importance, Fitch said.

However, some of those in the meeting stressed the importance of maintaining the granularity of municipal credits that many say the current scale represents. For example, Utah Treasurer Edward Alter said that although issuers may want their ratings bumped up, investors are likely to maintain the relative position of issuers when evaluating credits.

"As long as they maintain the kind of differentiation that we see now among state credits, a new scale works as a well as an old scale," Alter said. "Whatever scale you adopt, it strikes me you will probably end up with the same interest rate you have now."

Market participants also expressed concern about Securities and Exchange Commission Rule 2a-7, which limits municipal money market funds from owning securities rated below double-A, and the potential a changed muni scale would have for bringing greater transparency to retail investors.

In late March, Fitch announced plans to examine the idea of joining the two rating scales, naming Grossman to head the new initiative. In addition to soliciting market opinion and feedback, Fitch has undertaken a review of municipal and corporate credits, running case studies of similarly rated bonds to evaluate their default rates, disclosure characteristics, and performance, Grossman said.

"We're really trying to calibrate the future performance of these two asset classes," Grossman said.

Fitch's actions are the latest from the rating agencies as they respond to criticism across the market that the municipal rating scale unfairly penalizes municipal credits despite a historical default rate much lower than that of similarly rated corporate bonds. Congressional leaders and issuer officials like California Treasurer Bill Lockyer have been vocal about the need to change the current scale.

Tom Dresslar, a spokesman for the treasurer, said the state was happy with the meeting. Other meeting participants said the rating agency seemed very open minded in addressing the issue.

"We appreciate Fitch's willingness to engage issuers and other market participants on this critical issue," Dresslar said. "We look forward to a continuing dialogue to help produce a system that better serves the interest of taxpayers, investors, and the market."

However, the form that a changed muni rating scale will take remains to be seen. Discussion in the meeting debated the merits of a single scale for all debt, compared to the introduction of an additional scale, according to the rating agency. Some voiced concern that two scales would in fact complicate the issue rather than clarify it.

Regardless, there is some reason for optimism, meeting attendees said. Pennsylvania Treasurer Robin L. Wiessmann, who also attended the meeting, believes a solution must address the inherent complexity and interconnectedness of both the public and private sectors, while presenting municipal credits in a simple way easily understood by the marketplace. This is the crux of the discussion, she said.

"If we want their rating to be effective and sophisticated, we have to find better vehicles and better tools to obtain the best reflective ratings," Wiessmann said. "This whole credit crisis has underscored this complexity and we'd be silly to stick our heads in the sand about this."

The meeting included representatives of: AllianceBernstein, Blue River Funds, Fidelity Management and Research Co., Morgan Stanley/Van Kampen Investment Management, the California State Treasurer's Office, the Florida Division of Bond Finance, the Minneapolis Finance Department, the New York City Office of Management and Budget, the Pennsylvania Treasury Department, and the Utah State Treasurer's Office.